OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

September 11, 2001

Number: **200150012**
Release Date: 12/14/2001
CC:FIP:Br.3
TL-N-5595-00
UILC: 163.00-00
263.21-00
1092.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR MICHAEL J. COOPER
ACTING ASSOCIATE AREA COUNSEL CC:LM:NR:DEN

FROM: Lon B. Smith, Acting Associate Chief Counsel CC:FIP

SUBJECT: Financial Instrument Characterization

This Chief Counsel Advice responds to your memorandum dated May 7, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Company A =

Company B =

Instruments =

Issue Date =

Maturity Date =

a =

$b =

$c =

d =

e% =

$f =

g% = _______

Trustee =

h% = ____

i% = ____

Exchange Note =

Forward Contract =

ISSUES

(1) Are the quarterly payments on the Instruments, further described below, “interest” deductible under § 163(a) of the Internal Revenue Code?

(2) Are the Instruments part of a straddle subject to the capitalization rules of § 263(g)?

CONCLUSIONS

(1) The Instruments are not debt instruments and, therefore, the quarterly payments cannot be “interest.” The quarterly payments are, therefore, not deductible under § 163(a).

(2) The Instruments are part of a straddle subject to the capitalization rules of § 263(g).

FACTS

On or about Issue Date, Company A issued a units of the Instruments. The proceeds of such issuance to Company A were $b in the aggregate or $c per unit (less the underwriting discount). The proceeds of the issuance were used for general corporate purposes, including the reduction of short-term and long-term borrowings and other business opportunities. When the Instruments were issued, Company A owned approximately d shares of Company B common stock. At the end of the day that was six days prior to Issue Date, the Company B common stock had a fair market value of $c per share. The aggregate issue price of the Instruments was equal to the fair market value of a shares of Company B common stock six days prior to Issue Date.

Under the terms of the Instruments, Company A made quarterly payments that resulted in a yield of e% per annum based on initial issue price. At maturity, the Instruments were exchangeable for Company B shares on a sliding scale that depended on the value of the Company B common stock on the Maturity Date: (1) if the value of a share of Company B common stock on the Maturity Date was equal to or less than $c, each unit would be exchanged for one share of Company B common stock; (2) if the value of a share of Company B common stock on the Maturity Date was greater than $c but less than $f, then the Instruments would be exchanged for a fractional share of Company B common stock with a fair market value equal to $c; (3) if the value of a share of Company B common stock was $f or greater, the Instruments would be exchanged for g% of a share of Company B common stock (the "Exchange Rate"). However, Company A had the sole discretion to decide to deliver cash equal to the market value of the Company B shares rather than the shares themselves. In addition, no fractional shares of Company B common stock will be issued at maturity. In lieu of any fractional share otherwise issuable, such holder shall be entitled to receive an amount in cash equal to the value of such fractional share.

The Exchange Rate is subject to adjustment upon the occurrence of certain events. The rate may be adjusted, if necessary, to provide anti-dilution protection to holders of the Instruments upon the occurrence of certain dilution events. Also, the rate may be adjusted upon the occurrence of certain reorganization events (for example, any consolidation or merger of Company B with or into another entity). An adjustment upon the occurrence of certain reorganization events may require a change in the consideration received by the holders of the Instruments. No adjustments will be made for certain other events, such as offerings of Company B common stock by Company B for cash or in connection with acquisitions.

The Instruments were issued subject to an Indenture giving the holders enforceable rights against Company A. The Instruments are unsecured and unsubordinated obligations of Company A and rank equally and ratably with Company A's other unsecured indebtedness. The Instruments are not subject to redemption or any sinking fund prior to maturity. In the event of default (for example, a default in the payment of interest on the loan), either the Trustee or the holders of not less than h% in "principal" amount of the Instruments outstanding of that series may declare the "principal" amount of all Instruments to be due and payable immediately. The Instruments confer no rights with respect to Company B common stock (including, without limitation, voting rights and rights to receive any dividends or other distributions in respect thereof) until such time, if any, as Company A shall have delivered shares of Company B common stock to holders of the Instruments.

Company A's position with respect to the federal income tax consequences of the Instruments is that the Instruments consist of (i) a written debt obligation bearing a stated rate of interest (the "Exchange Note), and (ii) a forward purchase contract in which the holder agrees to use the principal payment due on the debt obligation to purchase at maturity Company B common stock (the "Forward Purchase Contract"). Company A acknowledges, however, that the proposed Treasury regulations concerning the treatment of contingent debt instruments under the original issue discount regime could apply to these Instruments but for the effective date of the regulations. Company A acknowledges that, for federal income tax purposes, there are no statutory, judicial, or administrative authorities that directly address the characterization of these Instruments.

LAW AND ANALYSIS

1. Are the Instruments properly characterized as debt instruments?

Under § 385(a) of the Internal Revenue Code, the Secretary of the Treasury is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an "interest" in a corporation is to be treated as stock or indebtedness (or as in part stock and in part indebtedness). Section 385(b) sets forth factors that the regulations should take into account in determining whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. These factors include, but are not limited to, the following: (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth and to pay a fixed rate of interest; (2) whether there is subordination to or preference over any indebtedness of the corporation; (3) the ratio of debt to equity of the corporation; (4) whether there is convertibility into the stock of the corporation; and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

Under § 385(c)(1), the characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness is binding on the issuer and on all holders of such interest (but is not binding on the Secretary of the Treasury).

Proposed regulations under § 385(a) were issued on March 24, 1980, which set forth the factors to be considered in determining whether instruments were stock or debt. Final regulations under § 385(a) were then issued in December 1980 (with a delayed effective date that was extended several times). The final regulations, however, were withdrawn in 1983. T.D. 7920, 1983-2 C.B. 69. There currently are no regulations under § 385.

Notice 94-47, 1994-1 C.B. 357, provides that the characterization of instruments as debt for federal income tax purposes depends on the terms of the instruments and all surrounding facts and circumstances. Among the factors that may be considered in making such a determination are: (1) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future; (2) whether holders of the instruments possess the right to enforce the payment of principal and interest; (3) whether the rights of the holders of the instruments are subordinate to rights of general creditors; (4) whether the instruments give the holders of the instruments the right to participate in the management of the issuer; (5) whether the issuer is thinly capitalized; (6) whether there is identity between holders of the instruments and stockholders of the issuer; (7) the label placed upon the instruments by the parties; and (8) whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes. The weight given to any factor depends upon all of the facts and circumstances. John Kelley Co. v. Commissioner, 326 U.S. 521 (1946).[1]

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[1] The Ninth Circuit of the United States Court of Appeals has considered the following eleven factors in classifying instruments as either debt or equity: (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation and management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of “dividend” money; and (11) the ability of the corporation to obtain loans from outside lending institutions. O.H. Kruse Grain & Milling v. Commissioner, 279 F.2d 123 (9th Cir. 1960).

We need not discuss here whether these Instruments entitle their holders to an equity interest in Company A or its subsidiaries. Clearly they do not. An equity holder (i.e., a shareholder) has an ownership interest in the corporate assets. Here, the holders of the Instruments do not have any right to Company A's corporate assets other than the Company B stock as a result of holding the Instruments. Nor do the holders have any current right to own Company A's stock as a result of holding the Instruments. Nor are the Instruments convertible in whole or in part into Company A stock. If an equity interest is implicated, it is with regard to Company B's stock and its assets.

Accordingly, the only question that we decide herein is whether these Instruments constitute debt. Thus, the following Notice 94-47 factors indicate whether characteristics of debt are implicated:

(1) Is there an unconditional promise to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future?

An important factor used in classifying instruments as debt is whether the instruments have a definite maturity date on which the creditor is entitled to an unconditional repayment of a fixed principal amount. The presence of a fixed maturity date indicates a definite obligation to repay, which is a characteristic of debt. The absence of a fixed maturity date indicates something other than debt.

In this case, Company A has an unconditional obligation to exchange these Instruments on the Maturity Date into either Company B common stock at the Exchange Rate, or cash in an amount equal to the amount of Company B common stock the holder would otherwise be entitled to receive under the Exchange Rate. Here, the Instruments mature on the Maturity Date. Consequently, in this case, the maturity date is fixed and is in the reasonably foreseeable future. However, the sum payable at maturity is not certain but is based on the future market value of the Company B common stock.

In Gilbert v. Commissioner, 248 F.2d 399 (2nd Cir. 1957), cert. denied, 359 U.S. 1002 (1959), the court concluded that the first prerequisite of an interest deduction is indebtedness—an existing, unconditional, and legally enforceable obligation to pay a sum certain at a fixed maturity date. If there is no promise to pay a principal amount, there is no indebtedness on which interest can be paid. Johnson v. Commissioner, 108 F.2d 104 (8th Cir. 1939).[2]

[2] Section 385(b)(1) provides that the existence of a written unconditional promise to pay on demand or at a specified date a sum certain in money is a factor to be considered in determining whether a debtor-creditor relationship exists.

Here, if at maturity, the market value of the Company B common stock is: (a) less than $c, the holder of the Instruments receives one share of Company B common stock for each Instruments exchanged, thereby he alone suffers a loss in the amount of the depreciation in value of the Company B common stock below the principal amount of the Instruments; (b) greater than $c but less than $f, the holder of the Instruments receives a fractional share of Company B common stock equal to the principal amount of the Instruments exchanged, and therefore he does not share in any of the appreciated value of the Company B common stock; and (c) greater than $f, the holder of the Instruments receives an amount of Company B common stock equal to the principal amount of the Instruments held ($c per Instruments) plus the holder shares with Company A in the appreciation of value in excess of $f. Therefore, the amount the holder would receive on the Instruments at maturity is not fixed but variable, based on the market value of Company B stock on or around the Maturity Date.

(2) Do the holders of the Instruments possess the right to enforce the payment of principal and interest?

Another important factor used in classifying instruments as debt is whether the holder of the instruments has the right to enforce the payment of principal and interest. A fixed right to enforce the payment of principal and interest by the holder is a characteristic of debt.

The Instruments here were issued under an Indenture between Company A and the Trustee. According to the provisions of the Indenture, if an event of default occurs (for example, if Company A fails to make payment of interest on the Instruments), the holders of the Instruments have certain creditor rights. For example, the holders of not less than h% in principal amount of the Instruments outstanding have the right to declare the principal amount of all Instruments to be due and payable immediately (which is referred to in the Indenture as a “declaration of acceleration”).

The Trustee may also declare the principal amount of all Instruments outstanding to be due and immediately payable in the event of default. The holders of not less than a majority of aggregate principal amount of all outstanding Instruments have the right on behalf of the holders of all outstanding Instruments to waive certain defaults.

Although in form, the holders have remedies typical of bondholders, it is important to note that unlike bondholders, they do not have the right to enforce the payment of “principal and interest,” as described under the Indenture. There is no fixed principal amount to be received under the Instruments, as discussed under factor (1), above, whether on the scheduled Maturity Date or on an accelerated date under the Indenture. Thus, this factor indicates that Instruments are something other than debt.

(3) <u>Are the rights of the holders of the Instruments subordinate to rights of general creditors?</u>

A characteristic of a debtor-creditor relationship is that the instruments are not subordinated to the claims of general creditors. The lack of subordination is a characteristic of debt. Instruments are not automatically denied debt status if they are subordinate to the claims of general creditors but rank ahead of the claims of the issuer's preferred and common stockholders. Moreover, debt status generally is not impaired if payments can be made on the instruments while senior claims are outstanding.

In this case, the Instruments are unsecured and unsubordinated obligations of Company A and rank equally and ratably with Company A's other indebtedness. Therefore the Instruments are not subordinate to the unsecured indebtedness of general creditors. The Instruments rank superior to the claims of holders of Company A's common stock. However, in contrast to a typical debt instrument, the holders of the Instruments are subject to a second set of credit risks: Company B's as well as Company A's. In effect, the rights of the holders of the Instruments are subordinated to all of Company B's creditors, and rank pari passu with the holders of Company B's common stock. A Company B bankruptcy would devastate the holders of the Instruments, without regard to the strength of Company A's credit standing.

(4) <u>Do the Instruments give the holders the right to participate in the management of the issuer?</u>

The holders of the Instruments do not have any voting rights. In certain situations (for example, in the event of default under the loan agreement) the Trustee or the holders of a majority in aggregate principal amount of the Instruments outstanding can direct the time, method, and place of conducting any remedy available to the Trustee with respect to the Instruments. In addition, certain actions (for example, amendment of the loan agreement and certain other modifications to the Indenture) cannot be taken without the approval of the holders of a majority in principal amount of the Instruments outstanding. These rights provide the holders of the securities very limited rights to participate in (or affect) the management of Company A. Such limited rights are characteristic of debt.

(5) <u>Is the issuer thinly capitalized?</u>

In general, if a corporation has a nominal stock capitalization coupled with excessive debt, this fact would tend to indicate that instruments were not debt.

Consequently, the debt-equity ratio (or percentage of debt) is another factor used to determine whether instruments are debt. The debt-equity ratio (or percentage of debt) indicates to what extent a corporation may suffer losses without impairment of the interests of a corporation's creditors. A high ratio (or high percentage) lowers the protection afforded to the creditors against sudden business slumps. As a result, a high ratio of debt to equity (or high percentage of debt) indicates that the issuance of the instruments is a contribution to capital rather than a bona fide loan.

In this case, Company A was not thinly capitalized and its debt-equity ratios during the period the Instruments were issued appears to be i%, within the range of acceptable ratios. Although Company A is not thinly capitalized, we do not believe this fact supports according debt treatment to the Instruments. Thin capitalization traditionally is used as a factor because it aids in determining whether an investor with a nominally fixed return in fact is at a substantial risk that the amount or timing of that return will turn on the risks of a business. The Instruments are designed to provide a variable return which corresponds with the performance of Company B's stock. From the investors' standpoint, they are at the risk of Company B's business and of Company A's venture in holding that stock, no matter how well Company A is capitalized.

(6) Are the holders of the Instruments and the stockholders of the issuer the same?

The relationship between a holder's ownership of a corporation's stock and debt is another factor used to determine whether instruments are debt (a disproportionate relationship). This factor could be relevant if a particular holder owns both Company A's stock and the Instruments. However, there is no indication that the holders of the Instruments own a proportionate amount of the stock of Company A. Therefore, this factor has neutral impact on this analysis.

(7) What labels are placed on the Instruments by the parties?

In general, the issuance of instruments labeled bonds, debentures, or notes is indicative of debt. In this case, the titles of the Instruments, Exchange Note and Forward Contract, are indicative of both debt and non-debt. Thus, such labels are ambiguous. These descriptions would be meaningful to potential investors, for whom the degree of participation in Company B stock presumably was the most salient term. The Instruments do have some formal characteristics of debt, and Company A has treated the Exchange Note portions of the Instruments as debt for federal income tax purposes.

Under § 385(c), the issuer's characterization of instruments (as of the time of issuance) as debt is binding on the issuer and on all holders of the instrument. However, this characterization is not binding on the Service or on a holder that discloses that it is treating the instruments in a manner inconsistent with the issuer's characterization.

(8) Are the Instruments intended to be treated as debt for non-tax purposes, including regulatory, rating agency, or financial purposes?

The intent of the parties regarding the treatment of the instruments as debt for non-tax purposes is an important factor in determining whether a debtor-creditor relationship or a corporation-shareholder relationship exists. For purposes of this factor, the treatment of the instruments for non-tax purposes may be relevant.

It is clear that Company A treated the Exchange Note portion of these Instruments as debt for federal tax purposes. However, neither the Indenture nor the Prospectus clearly portrays how Company A treated these Instruments for non-tax purposes. Thus, we cannot determine whether this factor indicates debt.

Other factors

Other factors that may be relevant in classifying instruments as either debt or non-debt for federal income tax purposes include the following:

(1) Convertibility of the instruments into stock of the issuer (a non-debt characteristic). In this case, the Instruments are not convertible into the stock of the issuer. At maturity, the Instruments must be converted into Company B common stock, or equivalent cash value. The amount of Company B common stock receivable by the holders of the Instruments at maturity depends solely upon the market value of Company B common stock.

(2) A sinking fund (a debt characteristic). In this case, there is no sinking fund provision.

(3) Contingent payments (a non-debt characteristic). In this case, the amount payable at maturity is contingent upon the market value of Company B common stock.

(4) Ability of the issuer to obtain loans from outside lending institutions (a debt characteristic). In this case, it appears that Company A could have borrowed from outside lending institutions; indeed we believe that all or most holders of the Instruments are unrelated to Company A. However, many conventional lenders could not or would not invest on these terms because the promised return is not a lender's, but an equity investor's return. Because the Instruments are mandatorily convertible into Company B common stock, we would expect the Instruments to have been sold to investors who were able to take common stock-type risks and were interested in a common stock-type of return.

Summary

While Company A has described the Instruments as indebtedness of the corporation, this characterization is not binding on the Service. Company A has an existing, unconditional, and legally enforceable obligation to exchange the Instruments at a fixed maturity date for Company B common stock. However, the amount Company A had to pay at maturity did not reflect a sum certain. The amount of stock each holder received at maturity did not depend on the principal amount of the Instruments held, rather it is contingent on the market value of Company B common stock. Thus, whether the holder of the Instruments was compensated at maturity and the amount of such compensation was subject to the risk of Company B's success.

The presence of a sum certain payable at maturity is a sine qua non of debt treatment under the Code. In Towne Square, Inc. v. Commissioner, the court stated, "[a] bona fide debt...is classically "an unqualified obligation to pay a sum certain..." [and that t]he certainty of the payment of principal and interest is one of the most important factors to be utilized in judging the true nature of advances." 45 T.C.M. 478 (1983), citing Gooding Amusement Company v. Commissioner, 23 T.C. 408, 418-19 (1954). Moreover, the court in Commissioner v. Page Oil Co., which found an instrument to be debt stated that "[t]he fact that ultimately [one] must be paid a definite sum at a fixed time marks his relationship to the corporation as that of creditor rather than shareholder." 129 F.2d 748, quoting Commissioner of Internal Revenue v. O.P.P. Holding Corp., 76 F.2d 11, 12, 35-1 U.S. Tax Cas. (CCH) P9179 (2nd Cir. 1935). See also Gilbert v. Commissioner, supra.

Notwithstanding the foregoing, it is clear that bona fide debt instruments may include contingent payments. See § 1.1275-4 (discussing the accrual of original issue discount on contingent payment debt instruments). Nevertheless, if the contingencies are such that it is entirely possible that the investor will never receive the return of his initial investment, it is difficult to conclude that the instruments include the promise to repay a principal amount which is indicative of debt. Similarly, payments received seem more like a return on an equity investment and thus not within the traditional definition of “interest” as “the amount one has contracted to pay for the use of borrowed money.” Deputy v. DuPont, 308 U.S. 488, 498 (1939).

Company A has a noncontingent obligation to make quarterly payments during the term of the Instruments. Nevertheless, the total amount of the noncontingent payments on each unit is substantially less than the issue price of each unit. Thus, it is entirely possible that a holder of the Instruments will never receive the amount of his initial investment. Based on the facts of this case and the factors described above, the Instruments should not be treated as debt for federal income tax purposes.

2. Are the Instruments part of a straddle subject to the capitalization rules of § 263(g)?

(a) Are the Instruments and the Company B common stock part of a straddle?

Under § 1092(c)(1), the term “straddle” means offsetting positions with respect to personal property. Section 1092(c)(2)(A) provides that a taxpayer holds offsetting positions with respect to personal property if there is substantial diminution of the taxpayer’s risk of loss from holding any position with respect to personal property by reason of holding one or more other positions with respect to personal property (whether or not of the same kind).

Section 1092(d)(1) defines personal property as any personal property of a type which is actively traded. Section 1092(d)(3)(A) sets forth the general rule that stock is excluded from the definition of personal property. Under § 1092(d)(3)(B), the general rule excluding stock from the definition of personal property does not apply in three situations. The first two exceptions apply to any stock that is part of a straddle in which at least one of the offsetting positions is (1) an option with respect to that stock or substantially similar stock or securities; or (2) as provided in regulations, a position with respect to substantially similar or related property (other than stock). §§ 1092(d)(3)(B)(i)(I)-(II).[3]

[3] The third exception provides that personal property includes any stock of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder. § 1092(d)(3)(B)(ii). This exception is not relevant to the instant case.

In this case, the taxpayer has a long position in the equity of an unrelated issuer referenced by the Instruments. The issuance of the Instruments results in a straddle if one of the § 1092(d)(3)(B) exceptions is applicable.

(1) If the Instruments are treated as a collar

In Rev. Rul. 88-31, 1988-1 C.B. 302, the Service held that § 1092 applied to a taxpayer that held publicly traded stock and cash settlement contingent payment rights relating to that stock. A corporation had issued investment units, consisting of one common share and a separately tradeable contingent payment right, the value of which varied inversely with the market value of the underlying common stock. The contingent payment would be made to the holder two years after the date of issue of the right. The Service concluded that the contingent payment right was a property right separate from the common stock. It next determined that the right was a cash settlement put option under § 1234(c)(2). The contingent payment right also constituted an option for purposes of the stock straddle exception of § 1092(d)(3)(B)(i)(I).

Similarly, in the instant case, the Instruments may be analyzed as cash settlement collars, that is, a combination of put and call options.[4] If such an

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[4] In this view, the Instruments represent a combination of options on Company B common stock. Specifically, the Instruments are equivalent to a "collar" such that Company A has purchased a put option and has written a call option that will be exercised at different strike prices.

A holder of a put option has taken a "short" position in the underlying security. That is, the holder will make money if the value of the security has fallen below the "strike price" since the holder can force the grantor of the put to purchase the security at greater than the security's fair market value. In the instant case, Company A is in a situation analogous to the holder of a put option since it has sold each unit of the Instruments for $c. However, if the fair market value of the Company B common stock falls below $c, it need merely give each holder of the Instruments a share of Company B common stock per unit or cash equal to the market value of the Company B stock. Thus, one could say that as holder of the put option embedded in each of the Instruments, Company A has the right to sell Company B stock at the strike price of $c. Of course, this analogy is not exact since the holder of a put option typically receives the strike price only at the time the put is exercised rather than, as in this case, when the option is first created. Similarly, the holder of the option usually makes an up-front "premium" payment to purchase the option (although, in this case, the noncontingent quarterly payments might be viewed as the equivalent of a premium payment or, alternatively, the purchase price for the Instruments might be viewed as a net amount reflecting both the premium payment paid by Company A for its put and the premium analysis is applied, the exception of § 1092(d)(3)(B)(i)(I) will apply on its face. Therefore Company A's position in the Instruments and the Company B common stock will be a straddle provided that the two positions are offsetting.

In Rev. Rul. 88-31, the contingent payment right constituted a short position that served to substantially diminish the risk of loss from a decline in value of the underlying common stock. Therefore, the Service ruled that a taxpayer who held both the contingent payment right and the stock held a straddle subject to § 1092.

Similarly, in the instant case, Company A has a long position in Company B common stock by directly owning d shares. Company A has also taken a short position in the Company B common stock by issuing the Instruments. The economic cost of a decline in the market value of the Company B stock held by Company A is substantially diminished through the exercise of the "put" option embedded in the Instruments. Similarly, Company A's risk of loss from having written the call option embedded in the Instruments is substantially diminished by holding Company B common stock. Consequently, as in Rev. Rul. 88-31, Company A's position in the Instruments is an offsetting position that substantially diminishes Company A's risk of loss from holding the long position in the Company B common stock (just as holding the Company B common stock reduces Company A's downside risk from issuing the Instruments). Thus, by issuing the Instruments, Company A has entered into a straddle.

(2) If the Instruments are not treated as a collar

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payment paid by holders of the Instruments for the call option discussed in the next paragraph).

A grantor of a call option has also taken a "short" position in the underlying security. That is the grantor will make money if the value of the security does not rise above the "strike price" since the grantor receives a premium payment up front and the holder will not exercise its option to purchase the underlying security unless the fair market value of the security exceeds the strike price. In the instant case, Company A is in a situation analogous to the grantor of a call option for which the strike price is $f (although each unit of the Instruments is actually analogous to a call option on only g% of a Company B share). Thus, if the value of the Company B common stock exceeds $f per share, the holders of the Instruments will be in a position that is economically equivalent to the holder of a call option on g% of a share of Company B stock for each unit held. That is, for each dollar increase in value of a Company B share above $f, the holders of the Instruments will receive g% of a dollar per each unit held (either in the form of cash or in the form of the fair market value of each Company B share received).

In the instant case, the Instruments may also be analyzed as a single financial instrument rather than as a collar. For example the Instruments might be viewed as a type of a Notional Principal Contract (NPC). A NPC is defined by regulation as “a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount.” § 1.446-3(c). NPCs are defined to include equity swaps. The Instruments, by providing for payments at specified intervals and a final cash payment linked to the value of Company B common stock, are similar to an equity swap on Company B common stock. Alternatively, the Instruments might be likened to “prepaid forwards” in which the seller receives a cash payment at the commencement of the transaction in order to deliver in the future some amount of a commodity or security (in this case, Company B common stock). Also, the Instruments could be viewed as sui generis, subject to their own unique rules under the tax system.

Under any of these alternatives, the exception of § 1092(d)(3)(B)(i)(II) will apply so that Company A’s position in the Instruments and the Company B common stock will be a straddle.

Final regulations adopted under this section are effective for positions established after March 17, 1995 and, therefore, could apply to the Instruments and Company B common stock. § 1.1092(d)-2(b)(1). The regulations provide that stock and an offsetting position “with respect to substantially similar or related property (other than stock)” constitute a straddle. Substantially similar or related property is given the meaning provided in § 1.246-5 (other than § 1.246-5(b)(3)) and so includes property if the fair market value of property and stock reflect the performance of a single enterprise. §§ 1.246-5(b)(1)(i)(A), 1.1092(d)-2(a). In the instant case, since fluctuations in the value of the Instruments would approximate changes in the value of Company B common stock, the Instruments would be within the definition of “substantially similar or related property” to the Company B common stock. As developed previously, Company A’s positions in the Instruments and the Company B common stock are offsetting. Therefore, under the regulations, the Instruments and Company B common stock are a straddle.

(3) <u>Are the Instruments and the Company B common stock part of a straddle subject to the capitalization rules of § 263(g)?</u>

Section 263(g)(1) states that no deduction shall be allowed for “interest and carrying charges” properly allocable to personal property which is part of a straddle as defined in § 1092(c). Section 263(g)(2) defines “interest and carrying charges” to mean “interest on indebtedness incurred or continued to purchase or carry the personal property” and “all other amounts (including charges to insure, store, or transport the personal property) paid or incurred to carry the personal property... . ” net of certain receipts with respect to the personal property.

As developed previously, the Instruments should not be characterized as debt. Consequently, the quarterly payments cannot be characterized as interest. However, the quarterly payments will be within the definition of carrying charge if the payments are an amount "paid or incurred to carry the personal property" (emphasis added). § 263(g)(2)(A)(ii).

There is no direct authority interpreting the term "carry" for the purposes of § 263(g).[5] However, the phrase "interest on indebtedness incurred or continued to purchase or carry" appears in § 265(a)(2) as well as § 263(g)(2)(A)(i). Section 265(a)(2) provides that no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry tax-exempt bonds. Rev. Proc. 72-18, 1972-1 C.B. 740, establishes administrative guidelines for the audit of cases involving § 265(a)(2). Among other things, Rev. Proc. 72-18 provides guidelines for the application of the "purchase or carry" phrase in § 265(a)(2) to require disallowance of interest only if: (1) the proceeds of the indebtedness can be directly traced to the purchase of the tax-exempt obligations; (2) the tax-exempt obligations are pledged to secure the indebtedness; or (3) the totality of the facts and circumstances support a reasonable inference the indebtedness was issued to purchase or carry the tax-exempt obligations. Significantly, one of the sets of facts and circumstances that Rev. Proc. 72-18 discusses as specifically indicating a purpose to carry tax-exempt obligations occurs if "a corporation *continues* indebtedness which it could discharge, in whole or in part, by liquidating its holdings of tax-exempt obligations without withdrawing any capital which is committed to, or held in reserve for, the corporation's regular business activities." Rev. Proc. 72-18 at § 6.02 (citing Illinois Terminal Railway Company v. United States, 375 F.2d 1016, 1021 (Ct. Cl. 1967)).

Interpreting the term "carry" in § 263(g)(2)(A)(ii) by reference to § 265(a)(2) and Rev. Proc. 72-18 is subject to certain objections. To begin with, § 265(a)(2) denies deductions for interest, not "carrying charges." Therefore, turning to a revenue procedure that interprets § 265(a)(2) to aid in defining "carrying charges" is somewhat inapposite. Indeed, the mere fact that § 265(a)(2) does not deal with carrying charges suggests that the term "carry" in § 265(a)(2) has a more limited meaning than in § 263(g). In addition, reliance on Rev. Proc. 72-18 somewhat overstates the significance of the revenue procedure which establishes administrative guidelines for the audit of cases rather than legal interpretations. The revenue procedure itself is clear that the governing test for determining

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[5] On January 18, 2001, the Service published proposed regulations under § 263(g) at 66 F.R. 4746. REG-105801-00, 2001-13 I.R.B. 965. However, the proposed regulations would not apply to straddles created prior to January 17, 2001 and, therefore, are inapplicable . Proposed § 1.263(g)-5. Consequently, the proposed regulations will not be further discussed here.

whether interest meets the statutory nexus test of § 265(a)(2) is set forth in case law. See, e.g., Illinois Terminal Railway Company v. United States, 375 F.2d 1016 (Ct. Cl. 1967) and Wisconsin Cheeseman, Inc. v. United States, 388 F.2d 420 (7th Cir. 1968). Finally, Rev. Proc. 72-18 does not give a definitive interpretation for the phrase “incurred or continued to purchase or carry” since Rev. Proc. 72-18 incorporates a “facts and circumstances” test that is, itself, subject to further interpretation.

Nevertheless, even though the term “carry” may have a broader meaning in § 263(g) than in § 265(a)(2), it is useful to consider whether the Instruments carry the Company B common stock if “carry” is given the meaning used in § 265(a)(2). Rev. Proc. 72-18 treats interest on a borrowing as carrying tax-exempt obligations if the obligations are first purchased and then pledged as collateral to secure the borrowing. That is, Rev. Proc. 72-18 implies that money is fungible and a taxpayer generally cannot avoid the application of § 265 by raising money to purchase tax exempt obligations indirectly rather than directly. Therefore, had Company A used its existing investment in Company B shares to raise cash by pledging the shares to secure a loan, Rev. Proc. 72-18 indicates that interest on the loan “carries” the Company B stock. Accord Wisconsin Cheeseman v. United States, 388 F.2d at 422 (“[O]ne who borrows to buy tax-exempts and one who borrows against tax-exempts already owned are in virtually the same economic position”). The question is: can we infer a similar intent to carry Company B common stock if Company A monetizes a significant portion of its existing economic interest in Company B not by formally pledging the Company B stock but instead by selling an obligation that is tied to the economic performance of the Company B stock?

Section 6.02 of Rev. Proc. 72-18 infers a purpose to carry tax exempt obligations if a corporation continues indebtedness which it could discharge by liquidating tax-exempt obligations. Similarly, we can infer such an intent upon Company A to carry Company B stock.

Company A, by issuing the Instruments rather than pledging the Company B stock, has reduced its risk from a decline in the value of Company B stock and its ability to gain from the appreciation of Company B stock. By issuing the Instruments, Company A has evidenced a willingness to cede substantial elements of its ownership rights in the Company B stock (that is, its right to gain and risk of loss) for an up-front payment. Thus, issuing the Instruments was effectively an alternative to liquidating part of the investment in the Company B stock. Therefore, one can reasonably infer on the basis of the totality of the facts and circumstances that the Instruments were incurred to continue the investment in the Company B stock and, therefore, “carry” the Company B stock. Cf. Illinois Terminal Railway Company v. United States, 375 F.2d at 1021; Rev. Proc. 72-18, § 6.02.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

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Please call if you have any further questions.

Sincerely yours,
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